Donald L Kohn: Risk management and its implications for systemic risk

Testimony of Mr Donald L Kohn, Vice Chairman of the Board of Governors of the US Federal Reserve System, before the Subcommittee on Securities, Insurance, and Investment, Committee on Banking, Housing, and Urban Affairs, US Senate, Washington DC, 19 June 2008.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

* * *

Chairman Reed, Ranking Member Allard and members of the Subcommittee, it is my pleasure to appear today to discuss several issues related to the oversight of financial institutions. First, I will discuss the circumstances leading to the establishment of our temporary facility for lending to primary securities dealers and our arrangements for monitoring their financial condition. Then, I will describe Federal Reserve activities related to the banking institutions we supervise, including concrete steps to address identified issues and to help these institutions improve risk management practices. Finally, I will briefly summarize planned enhancements to our consolidated supervision of bank and financial holding companies.

Federal Reserve monitoring activities related to the Primary Dealer Credit Facility

Three months ago, the Board approved the establishment of the Primary Dealer Credit Facility (PDCF). This action was taken pursuant to Section 13(3) of the Federal Reserve Act, which empowers the Board of Governors to authorize a Federal Reserve Bank to lend to a corporation, including a securities firm, in "unusual and exigent" circumstances when the corporation cannot "secure adequate credit accommodations from other banking institutions." In doing so, the Board of Governors made the necessary statutory finding that market circumstances were indeed unusual and exigent. We judged that without increased access to Federal Reserve liquidity by major securities firms, overall financial market conditions would have deteriorated further and would have had a substantially adverse effect on the economy.

We fully recognized that the use of this legal authority was an extraordinary step, but considered it necessary given the circumstances. To quickly design and implement a facility to provide this liquidity, we made use of existing business relationships with a group of 20 securities firms, known as primary dealers. The Open Market Desk of the Federal Reserve Bank of New York trades U.S. government securities with primary dealers to implement monetary policy on behalf of the Federal Reserve System. The PDCF makes available overnight funding to sound primary dealers in the form of loans secured by collateral eligible to be pledged in open market operations, plus investment-grade corporate, municipal, and mortgage-backed and asset-backed securities. The PDCF was authorized for a minimum period of six months.

Most of the primary dealers are owned by either U.S. or foreign banking organizations that have been approved as U.S. financial holding companies. The U.S. financial holding companies owning primary dealers are subject to consolidated supervision by the Federal Reserve, but for the primary dealers within financial holding companies we rely extensively on the Securities and Exchange Commission (SEC) as functional regulator. The SEC, rather than the Federal Reserve, serves as consolidated supervisor for the major U.S. investment banks with primary dealers. In connection with the establishment of the PDCF, we created a program to monitor the financial and funding positions of primary dealers, focusing on those primary dealers not owned by financial holding companies. From the beginning, we have coordinated closely with the SEC, and we are currently working on an agreement with that agency to enhance information sharing both for primary dealers that are part of financial holding companies and for those that are not.

The objectives of our PDCF monitoring program are: (1) to establish the basis for an informed judgment by the Federal Reserve of the liquidity and capital positions of the primary dealers accessing the PDCF; and (2) to minimize the risk that the availability of financing under the PDCF undermines the incentives for the consolidated entity to manage capital and liquidity to levels appropriate for a sustained period of market disruption.

The Federal Reserve's monitoring program for primary dealers includes a limited on-site presence at the four largest investment banks and has a narrower focus than our broader supervision and examination of state member banks, bank holding companies, and the U.S. operations of foreign banking organizations. Specifically, the Federal Reserve is not supervising investment firms comprehensively to assess risk management. Rather, our purpose is specifically to assess the adequacy of liquidity and capital.

To support our monitoring efforts, which are closely coordinated with the SEC, we receive internal information from the firms on a daily basis that enables us to identify changes in the level and composition of the firms' holdings of cash and unencumbered, highly liquid assets. We also receive qualitative information regarding the posture of counterparties and clients toward the firms, including the extent, if any, to which the firms are encountering difficulty in rolling over secured and unsecured funding. In addition, along with the SEC, we are assessing the firms' current and planned capital positions in light of their near-term earnings prospects. In both of these areas – liquidity and capital – we are evaluating the firms' efforts and, with the SEC, providing feedback to their senior management teams.

Broadly speaking, we believe that primary dealers are strengthening liquidity and capital positions to better protect themselves against extreme events. We also believe their management has learned some valuable lessons from the events of the recent financial turmoil that should translate into better risk management. We continue to monitor the effect of the PDCF and are studying a range of options going forward.

Federal Reserve supervisory activities

I would now like to discuss the Federal Reserve's recent activities relating to banking institutions we supervise. As I noted in testimony before the full Committee on June 5, recent events have highlighted a number of risk management lessons for banking organizations, many of which have been documented in recent public reports.[1] In that testimony, I outlined the Federal Reserve's broad supervisory responses to recent events, which include requiring banking institutions to improve risk management, augmenting existing supervisory guidance, and where necessary, enhancing our own supervisory processes.

Naturally, the risk management lessons from recent events vary by institution, since the types of deficiencies differed and some institutions fared better than others. Thus, in our supervisory efforts, we are taking these broad lessons and applying them to each institution as needed. But we can point to some general areas where we are focusing supervisory attention and encouraging better risk management at banking institutions. For one, supervisors are reinforcing and strengthening their assessments and testing of fundamental

---

[1] President's Working Group on Financial Markets (2008), "Policy Statement on Financial Market Developments", March 13;

Financial Stability Forum (2008), "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience", April 7;

Senior Supervisors Group (2008). "Observations on Risk Management Practices during the Recent Market Turbulence", March 6.

risk management processes, requiring vigorous corrective action when weaknesses are identified. We are ensuring that institutions take a more comprehensive and forward-looking approach to risk management across the entire firm, and are more intensely verifying assertions made by bank management about the robustness of their risk management capabilities.

Supervisors are also ensuring that banks understand the full spectrum and the scale of the risks inherent in increasingly complex banking activities and the potential for their risks to crystallize in times of stress. In particular, banks must focus on the inter-relationships among risk types, not just with respect to those areas that precipitated recent events, but more broadly.

In light of recent events, we have redoubled our efforts to ensure that senior management properly defines overall risk preferences and creates incentives for employees to abide by those preferences, such as effective firm-wide limits and controls. We are reminding banks of the importance of information-sharing throughout the entire organization and of the dangers of information silos. In addition, we are strongly encouraging institutions to improve and/or build out their risk functions, so that independent risk managers are empowered to dig deep for latent risks, including concentrations that often arise only in times of stress.

Having given some general thoughts on current supervisory issues and supervisory approaches to improving risk management, I would now like to turn to a few specific areas in which we are addressing the challenges facing institutions and helping bring about improvements in their risk management.

Residential lending

Risks associated with residential mortgage and home equity lending remain a top supervisory priority due to the continued negative trends in home prices, elevated levels of delinquencies and foreclosures, and slack demand for residential mortgage securities in the secondary markets. Banks continue to experience losses on residential first mortgage loans, especially, but not exclusively, on nonprime lending. Losses on home equity loans are also increasing significantly, even for lenders not heavily involved in subprime lending, and loss severities as a percentage of outstanding exposure on this product are greater than for first lien loans. And mortgage securities markets whose instruments are not supported by government-sponsored entities continue to be adversely affected by problems in the housing market, complicating banks' risk management in this sector.

Supervisors are acting on several fronts to address problems related to residential first and second mortgages. First, we are making sure institutions comply with our existing guidance on nontraditional mortgages and on home equity loans, issued in 2006 and 2005, respectively, as well as guidance on subprime lending issued last year. And we are evaluating institutions based on the risk management practices discussed in those guidance documents. We expect institutions to conduct rigorous stress tests of potential future losses related to residential mortgage loans, home equity lines, and mortgage-backed securities. We continue to encourage lenders and mortgage servicers to work constructively with borrowers at risk of default and to consider prudent workout arrangements to avoid unnecessary foreclosures. As you know, the Federal Reserve believes that prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower.

Furthermore, we are working to finalize the proposed amendments to the rules under the Home Ownership and Equity Protection Act that we proposed in December. The proposed amendments, which would apply to all creditors, would better protect consumers from a range of unfair or deceptive mortgage lending and advertising practices that have been the source of considerable concern and criticism. Our proposal includes key protections for higher-priced mortgage loans secured by a consumer's principal dwelling and addresses concerns about a lender's assessment of a borrower's ability to make the scheduled payments, including verification of the consumer's income and assets. The proposal also addresses concerns about prepayment penalties and the adverse impact on consumers of lenders failing to escrow for taxes and insurance. Protecting consumers also has benefits for lenders because it should reduce delinquencies and defaults that can occur when consumers do not understand or cannot afford certain types of loans. We are working toward issuing final regulations in July.

Commercial real estate lending

Commercial real estate (CRE) lending is another area that requires close supervisory attention. In 2006, well before CRE markets began to soften, property values began to level off or decline in certain markets, and fundamentals began to turn somewhat negative, the Federal Reserve and other banking agencies issued guidance on CRE concentrations. We were concerned that the increasing concentrations of CRE loans in the portfolios of many banks, especially small and medium-sized lenders, made them more vulnerable to a softening in this market if the risks were not well managed. Since then, delinquencies on construction loans have begun to rise, particularly for residential construction loans, and they are expected to rise further. Those institutions with high CRE concentrations in geographic areas suffering real estate pressures will likely bear losses. Further, the significant slowdown in the origination of commercial mortgage-backed securities will reduce banks' options to manage CRE portfolio risks through the secondary market.

As I noted in my March testimony on the condition of the U.S. banking industry, we have been stepping up our reviews of state member banks and bank holding companies exhibiting concentrations in CRE, especially in those areas of the country exhibiting signs of weakness. We continue to monitor banks' adherence to the supervisory guidance I just noted. These efforts include monitoring carefully the potential impact of lower valuations on CRE exposures. Through those reviews, we are identifying weaknesses in banks' risk management practices, including underwriting practices, appraisal processes, stress testing, and market analysis. Based on these results, we are updating our supervisory plans and examination schedules to focus our resources most effectively on those institutions presenting the greatest risk and needing the most improvement. Finally, we just concluded a Federal Reserve examiner training effort on CRE topics, including appraisal practices, loan loss allowances, stress testing, and board and management oversight. The training focused on the importance of ensuring prudent risk management practices, without unduly curtailing credit availability.

Counterparty credit risk

Concerns in financial markets about the creditworthiness of some financial intermediaries have eased somewhat since the first half of March, but those concerns remain relatively high. More fundamentally, the proper management of counterparty credit risk – which is the risk of loss from a counterparty's failure to perform its financial obligations – is a prerequisite for protecting the entire system from contagion when any one institution fails.

Consistent with the recommendations of recent reports, we are looking at how firms are addressing weaknesses in counterparty credit risk management practices highlighted by recent events, including the measurement and aggregation of exposures stemming from a wide range of transactions with both unregulated and regulated entities. For instance, we are emphasizing that firms should use a variety of techniques to measure potential exposure on over-the-counter (OTC) derivatives, repurchase agreements, and other contracts, and that they should aggregate all exposures to each counterparty. In this context, we have been closely monitoring counterparty exposures arising from transactions with monoline financial guarantors and have been discussing with banks the measurement and management of these positions.

In addition, we are working to strengthen the market infrastructure for financial transactions to make it more robust and more resilient. In particular, the Federal Reserve Bank of New York continues to work with domestic and international prudential supervisors of OTC derivatives dealers to strengthen the infrastructure for those large and rapidly growing markets. The supervisors are emphasizing to the major dealers and to other active market participants the importance of setting standards for the accuracy and timeliness of trade data submission and for the timeliness of resolutions of errors in trade matching for OTC derivatives contracts. Furthermore, consistent with the recommendations made in recent reports on turbulence in financial markets, supervisors are encouraging the development by the industry of a longer-term plan for an integrated operational infrastructure supporting OTC derivatives that captures all significant processing events over the entire lifecycle of trades, delivers operational reliability, and maximizes the efficiencies obtainable from automation and electronic processing platforms. In addition to supporting more robust exposure measurement and capture, these enhancements should strengthen participants' ability to manage counterparty risk through loss mitigation techniques such as the use of netting and collateral agreements. We are encouraged by recent industry efforts to address counterparty credit risk, such as plans to extend central counterparty clearinghouse services to credit derivatives and other initiatives.

Credit cards

Credit card charge-offs have continued to rise over the past several quarters, although charge-offs remain well below their early 2002 peak. Not surprisingly, some banks report that delinquency rates for unsecured consumer debt are generally higher in areas that have experienced significant home price depreciation and increased unemployment. In response to these trends, many issuers are tightening credit standards and reducing exposures in these higher risk markets. Rising delinquencies and increased card usage that has been reported in recent months are likely to push charge-off levels higher in future quarters. Therefore, we will continue to monitor credit card markets and other consumer lending sectors for potential weaknesses.

The Federal Reserve has also taken steps toward improving consumer protection for credit card users. Our first step was the Board's 2007 proposal to substantially revise and improve credit card disclosures under the Truth in Lending Act. In preparing this proposal, we conducted extensive consumer testing to determine the type and format of information that consumers find most useful in shopping for and choosing a credit card. This extensive consumer testing – and the thousands of public comments on our proposal – suggested that disclosures may not provide sufficient consumer protection with regard to certain practices. Therefore, we recently proposed rules under the Federal Trade Commission Act to protect consumers from financial harm caused by those practices. If implemented, the proposed rules would require financial institutions to make changes to their business models and to alter some practices. The Federal Reserve developed this proposal jointly with the Office of Thrift Supervision and the National Credit Union Administration. We are continuing to use consumer testing as we work toward issuing final rules for credit cards by year-end.

Commercial lending

Commercial lending activity, aside from a few sectors such as leveraged lending, has not been markedly affected by the recent volatility in the financial markets, but may encounter more difficulty should slow economic growth persist. Lenders and investors are demanding stricter underwriting standards and higher returns for commercial loans. With regard to the condition of existing commercial loan portfolios, delinquencies have been rising recently as has the volume of criticized assets. This has been most evident in the leveraged loan market, where lending standards appeared to weaken noticeably in recent years, and which tends to be more susceptible to soft economic conditions.

Supervisors are monitoring banks' commercial lending activities, particularly leveraged loan portfolios, to detect weaknesses in asset quality that may result from slowing economic conditions and to ensure appropriate risk management practices. In part, the agencies rely on their Shared National Credit (SNC) program to assess the credit quality of banks' commercial loan portfolios. The 2008 review is now underway and will provide additional insight into the condition of large syndicated credits that are shared by three or more banks, including an evaluation of underwriting practices and trends in the leveraged loan market and the broader syndicated loan market.

Adequacy of loan loss allowance

As the banking system has faced a more difficult environment in recent quarters, our examiners have identified significant weaknesses at some institutions in identifying and reserving against problem loans, which in some cases have led to deficiencies in allowance levels at some supervised institutions. In response, our examiners continue to remind bankers that allowance levels should be reflective of loan portfolio quality, based on sound processes, and consistent with current supervisory guidance. We recently provided additional clarity to our examiners regarding existing interagency guidance on loan loss allowances that should be factored into current examinations and inspections of state member banks, bank holding companies, and their nonbank subsidiaries. We believe this further clarity to our examination staff will help them in their regular discussions with bankers to ensure that reserving practices are robust and loan loss allowances are indeed adequate to the circumstances facing each institution.

Liquidity risk management

Recent reports cite the need for enhancement to liquidity risk management as one of the key lessons from recent events. Financial institutions must understand their liquidity needs at both the legal entity and enterprise-wide level and be prepared for the possibility that market liquidity may erode quickly, unexpectedly, and for a protracted time. As is now widely recognized, many contingency funding plans did not adequately prepare for the possibility that certain off-balance-sheet exposures might have to be brought onto the firm's balance sheet, calling on available liquidity. Nor did they adequately account for the possibility of widespread and protracted declines in asset market liquidity. While liquidity pressures in banking and financial markets have eased of late, we do recognize that institutions must prepare themselves for the possibility that liquidity problems could return, either market-wide or at an individual institution.

Supervisors are working with institutions to improve liquidity risk management practices. For instance, we are reviewing banks' contingent funding needs and sources of funding. We are ensuring that bankers develop appropriate short-term and long-term liquidity risk management strategies. Consistent with the findings of recent reports, we are emphasizing the importance of appropriate stress testing of liquidity needs and maintenance of robust liquidity buffers. In addition, we worked with our colleagues on the Basel Committee on Banking Supervision to enhance existing guidance on the management of liquidity risks, which was released two days ago. That work was drawn from recent and ongoing efforts on liquidity risk by the public and private sectors and is intended to strengthen banks' liquidity risk management and improve global supervisory practices. Of course, the Federal Reserve has undertaken a number of programs to bolster market liquidity.

Capital needs

Clearly, capital is a critical defense against unexpected losses. Even with the recent turmoil, the U.S. banking system remains well capitalized. However, as I noted in my June 5 testimony, we are encouraging institutions to raise capital as needed, in part so that they will be well positioned to take advantage of future opportunities and to support a strengthening of financial conditions and a rebound in economic growth. And the recent capital injections into banking organizations and other financial institutions are a good sign that investors see value in those institutions and in the banking industry as a whole.

To assess the sufficiency of firms' capacity to absorb unexpected losses from a wide range of sources, Federal Reserve supervisors have heightened their review of capital analysis and forecasting at banking organizations. Examiners are reviewing the reasonableness of assumptions banking organizations use to assess capital needs and are emphasizing forward-looking analysis. For example, we are evaluating banks' use of stress scenarios to see if they adequately incorporate a range of possible events and properly identify potential capital needs and capacity across the firms. The scenarios address a number of possible factors including unexpected balance sheet expansion, earnings deterioration across key business lines, and stress-level losses generated by a variety of positions and multiple sources.

In addition, last year the Federal Reserve conducted a review across a number of large banking organizations to assess these firms' use of so-called "economic capital" practices, which are a means for firms to calculate, for internal purposes, their capital needs given their risk profile. Consistent with other findings, we found that some banks relied too extensively on the output of internal models, not viewing model output with appropriate skepticism. Models are dependent on the data used to construct them. When data histories are short or are drawn mostly from periods of benign economic conditions, model results may not be fully applicable to an institution's risk profile. We concluded that banks would generally benefit from better evaluation of inputs used in their internal capital models, stronger validation of their models, and broader use of stress testing and scenario analysis to supplement the inherent limitations of their models. We are incorporating the results of this horizontal review in our current assessments of banks' overall capital adequacy, as well as using it to evaluate banks' readiness to meet the requirement in Pillar 2 of Basel II that banks develop their own internal process to assess overall capital adequacy, beyond regulatory capital measures.

Consolidated supervision program

The supervisory activities just described are intended to address many of the risk management lapses seen over the past year, some of which pertain to shortcomings in firm-wide risk identification and measurement. Consistent with our regular efforts to improve supervisory practices, we realize that our program of consolidated supervision could be enhanced and made more systematic. Supervising a consolidated banking organization requires review of all risks on an enterprise-wide basis, not just review of the risks contained in each subsidiary legal entity. To this end, the Federal Reserve is nearing completion of enhancements to its supervisory guidance to clarify our role as consolidated supervisor of bank and financial holding companies.

The updated consolidated supervision guidance, which will be publicly available, is primarily intended to provide greater clarity to our own examination staff. For example, it provides for more consistent Federal Reserve supervisory practices and assessments across institutions with similar activities and risks, detailing expectations for understanding and assessing primary governance functions and risk controls, material business lines, nonbank operations, funding and liquidity management, consumer compliance, and other key activities and risks. In this sense the forthcoming guidance is very consistent with the Federal Reserve supervisory actions I have just described. The enhanced guidance will help us better identify and address firm-wide issues at supervised banking organizations, while also promoting better risk management.

I want to make clear that consolidated supervision of bank and financial holding companies in the United States generally works well, with strong, cooperative relationships between the Federal Reserve and other relevant bank supervisors and functional regulators. Indeed, much of the supervisory work I just described is being done in cooperation with primary supervisors and functional regulators. Information sharing among relevant supervisors and regulators is essential to ensure that a banking organization's global activities are effectively supervised on a consolidated basis, and we have worked over the years to develop and enhance interagency coordination and information sharing. But as institutions grow larger and more complex, we need to ensure that our system of consolidated supervision keeps pace.

Finally, it is worth noting that the Federal Reserve's umbrella supervision role closely complements our other central bank responsibilities, including the objectives of fostering financial stability and deterring or managing financial crises. The information, expertise, and powers derived from our supervisory authority enhances the Federal Reserve's ability to help prevent financial crises, and to manage such crises should they occur, working with the Treasury Department and other U.S. and foreign authorities. In this manner, enhancements to our consolidated supervision program, which include close coordination with primary supervisors and functional regulators, should provide broad benefits for the financial system and the economy.